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What Comes Next: Visualizing the Future After the Great Pandemic of 2020 – Part 2

Legal Profession and Financial Transactions

(Part 2 of 3)

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This three-part article offers possible post-COVID-19 changes to our work environment, from a variety of perspectives: social, design, technology, marketing and sales, legal, financial and government. In part 1 – found [here](#) – the article looked at the impacts of the pandemic on social bonds, the workplace and government regulation.

In this part, the article examines the possible changes after the pandemic that could reshape the legal profession, as well as the financial management and parameters of future transactions. To paraphrase the former mayor of Chicago, I hope these thoughts may help us not waste this crisis and instead prepare for a brighter future.

Legal

The aftermath of the pandemic will unleash scrutiny in at least five areas described below.

Force Majeure/Excuse/Impracticability. Lawyers always focus on getting out of, and keeping the other side in, contracts. While many have in the past glossed over force majeure provisions, as well as discussion of other common law excuse concepts, you can bet that force majeure or excuse provisions for pandemics will be debated more and under more intense scrutiny. We have already seen provisions actually defining “pandemic.” We have also debated how geographically dispersed the pandemic has to be, how long in duration, how broad the affected masses, how disproportionate the impact on one party in relation to its industry and how disrupted the populace. Some have suggested that a pandemic is not appropriate to include in the litany of force majeure events since it is hardly unforeseeable. Others would dispute that point as tantamount to postulating that all Acts of God and wars, by virtue of their occurring, are therefore foreseeable; you just don’t know which Acts of God and wars and the specifics. In other words, just as we are prone to fight yesterday’s wars, we cannot assume that all pandemics are like one another.

Illegality as an excuse from performance is likely to become hotly contested. For example, does a shelter-in-place order prohibiting occupancy provide adequate grounds to abate rent payments? What if the tenant is an essential service but chooses to have its employees work from home? What if part of the tenant’s services is considered essential?

Business Interruption Insurance Policies. Business interruption insurance policies typically cover a business whose operations are interrupted due to “physical” damage or denial of entrance to the premises due to that physical loss. Mass pandemics hardly inflict physical damage except in the most theoretical, microbial sense. Pandemic coverage will certainly be specific areas of negotiation in the future. While premiums may be too high to justify obtaining, lenders may require some form of coverage for their borrowers. Disaster plans devising strategies for mitigating losses during a shelter-in-place directive will help lower premiums for these policies.

Landlord and Tenant Duties. The aftermath of the pandemic will provide greater scrutiny to and clarity of the respective parties’ duties in an office lease. For example, what level of daily cleaning does the landlord provide? How often are the premises hydro-scrubbed? How do the security personnel screen and admit health compromised visitors? When may access to the leased premises be denied due to outbreaks of an illness on the tenant’s floor? What about not on the tenant’s floor but somewhere else in the

building? What precautions are taken that the retail tenants maintain cleanliness and health? What happens to rent when access is denied or the building is evacuated due to any tenant? Due to shelter-in-place orders?

Material Adverse Effect Terminations. Many business purchase and sale agreements do not require a buyer to proceed to close the transaction if, between a specified date and the closing, an event or condition has occurred that has had or may or would reasonably likely have a material adverse affect on the seller, its business, properties, financial condition and sometimes even prospects. This clause, and even the words here are frequently contested and highly nuanced, and they contain several carve-outs that are equally nuanced and beyond the scope of this article.

Despite the presence of these clauses, very few courts have allowed buyers to refuse to close due to such an event. Sometimes, if the seller is disproportionately affected in relation to its industry brethren, this circumstance will provide greater sympathy and therefore relief. Suffice it to say that the parties will undoubtedly haggle over whether a pandemic constitutes sufficient grounds to refuse to close or at least delay closing. So many uncertainties exist with pandemics, including, for example:

- What geographic area was the pandemic predominantly located (e.g., if the spread only afflicted China at the time but not yet the United States, is that sufficient)?
- If only four states had shelter-in-place orders in effect, is that enough?
- If three of the four states were in locations where the seller had manufacturing facilities?
- If the entire country had shelter in place orders in effect but they were due to expire in one week? If the pandemic was more like SARS, where the illness is quite severe but the spread not highly contagious, will that do it?
- If a vaccine was almost ready?

Courts, generally loathe to encourage litigation and always desirous of enforcing the sanctity of a contract, will need to see clear and unmistakable verbiage addressing this issue before permitting a buyer to terminate or significantly delay closing a business transaction. If events like pandemics truly cause a buyer trepidation, it will likely attempt to sign and close simultaneously. This approach may not mollify a seller who is conversely desirous of inking an agreement, or a situation where a binding agreement is needed for financing or regulatory reasons.

Transactional Due Diligence and Purchase Agreement Considerations. Purchase investigations in typical commercial transactions are already intense and thorough. Heightened sensitivity to the post-COVID-19 deal world will certainly unleash evaluations on not just confirming the facts of the seller's business, but also modeling its susceptibility to and resilience in the face of possible future pandemics or other business interruptions. Not only force majeure clauses and other termination or delay rights will need to be analyzed, but also the seller's entire business operations. For example, where are seller's key vendors located? Are there backup vendors? Are the vendors able to allocate supplies among their customers? Does the seller have multiple sources of supply in case one source is excused or delayed? Do the key customers have the financial wherewithal to keep paying in a pandemic? Have they encountered payment or disruption issues, or downcycles, in the past?

If the buyer is really relying on seller forecasts and projections, then perform an intense sensitivity analysis testing underlying assumptions and possibly greater variations in revenue declines. Between signing and closing, what actions will seller be able to take to deal with pandemics and other adverse events without requiring buyer's consent? Can a seller update its disclosure schedules for material new items occurring after the signing without triggering any rights for the buyer to terminate or seek indemnification? Is working capital unduly aberrant given cycles where receivables might be stretched due to inordinate customer delays? Same with payables due to seller's payment delays? Are inventory levels and mix out of the ordinary due to slower sales during a crisis? These are just some of a myriad of new considerations for purchase and sale agreements the post-pandemic world will undoubtedly confront.

Financial

The monetary seismic aftershocks of the pandemic will reverberate in many ways, some of which are noted below.

More Cash on Hand. As previously noted, businesses may consider not living too close to the edge and consider keeping on hand at least two to three months of reserve to pay rent, payroll, utilities and other critical fixed costs. This might be prudent fiscal discipline even in good times and a munificent marketing tool to give employees some comfort that they will not be reflexively jettisoned at the first sign of a downturn.

Higher Maintenance and Service Costs. Maintenance and service costs might increase as employers become more cognizant of the need for a cleaner and safer workplace. This might include deeper cleaning, availability of more sanitizers, and need for more employee and guest screening and testing.

Technology Costs. Expenditures for technology are likely to increase but consider that technology pricing usually declines over time with scale and adoption, so perhaps that will not be as dramatic. The crucial need for workers to be connected all the time everywhere and possibly need to be remote for long periods of time underscores the recognition that it is not prudent to be miserly with tech spending.

Decreased Travel and Entertainment Costs. Greater technology use may decrease other costs such as travel and ultimately the need for office space, as more people regularly and systematically work remotely.

Higher Insurance Premiums. The cost of providing health care, not just to pay for all the COVID-19 cases but to underwrite future pandemics, will undoubtedly lead to higher insurance premiums. How employers share these increased costs with their employees is not only a financial matter but also a policy choice of the type of “safe” workplace image the employer desires to portray. Further, insurance premiums for business interruption coverage may also increase, even if the policyholder does not purchase pandemic coverage.

Migration to More Certain and Fixed Revenue Streams. To mitigate, if not avoid, the vicissitudes of hourly billing, professional services firms may consider more monthly fixed retainer models. This steady income, in good times and bad, could soften the slings and arrows of unpredictable cataclysms (assuming the clients stay solvent or do not renegotiate). The willingness of clients to pay fixed monthly retainers, however, may be problematic and, even if it is agreed to, may be reassessed at the first whiff of a downturn anyway. Ironically, many clients who had previously suggested a fixed cost arrangement with flat monthly retainers have recently started to see the benefits of a variable cost structure, which frees up monthly burdens during challenging times.

Possibly Lower Rent Costs. With more workers working remotely, less space will be needed. Of course, that need for lesser space may be offset by the required spreading out of personnel in the workspace, so maybe this will equalize itself.

More Zealous Monitoring of Cash Collection Cycle. Liquidity in the form of prompt receipts from clients and moderately stretched payments to vendors is essential to keep a business afloat and well capitalized. Certainly during any challenging economic set of circumstances, the cycle becomes elongated. The experience during the pandemic reinforced slavish devotion to the basic principles that Cash is King or Queen. Businesses likely would be expected to pursue this truism more slavishly to avoid defaults or delayed payments from customers. Prudent financial management will require retainers and staying replenished, as well as security deposits and not permitting advancing significant costs. Interest for late payments, late payment fees, early pay discounts, retainers, good relations, friendly but prompt reminder calls and follow-ups, credit card auto pay, and abrupt cessation of work are some tactics a business could be quicker to pursue to avoid being used by their customers as a bank.

Change in Business Valuations Initially Impacting Transaction Volume. Transaction volume in industries that use debt (private equity and commercial real estate to name a couple) could decline in the short run as buyers and sellers reorient basic financial valuation metrics. Transactions will still occur as strategic businesses, as well as those strictly trying to make money, will always perform the buy versus build calculus.

The key underpinning of any valuation is the appropriate risk premium, whether that is expressed as a cap rate in a real estate transaction, as an EBITDA multiple in a private equity deal or an ARR multiple in a SaaS venture capital deal. As the perceived risk

– not just of the micro business itself but of the macro geopolitical – increases, the multiples will adjust to lower the price. Valuations may decline further if a lower risk tolerance necessitates less debt and more equity in the capital structure, and therefore valuations would need to decline to keep return on equity at desired levels. Further, lenders might impose financial covenants that are more stringent and also more universally might require a minimum cash level requirement. Just as some lenders, particularly in real estate transactions, require interest reserves to cover some time period for interest payments, perhaps some lenders in the future will insist on a rainy-day reserve comprising at least 2-3 months of rent, payroll and utilities. This minimum cash level or reserve would presumably cushion the borrower from these external shocks to the economy. It also increases the cost of capital since the return on cash is not as high as on more productive assets.

In Part 3 of this article, we will take a look at the potential future of marketing and sales, as well as technology, that will be impacted by COVID-19.